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February 1, 2016

Board of Governors
Federal Reserve Board
c/o Robert deV. Frierson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and
Constitution Avenue NW.
Washington, D.C. 20551

Re: **Regulations Q and YY; Docket No. R–1523**

RIN 7100–AE37

Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies

Dear Governors,

On behalf of more than 400,000 members and supporters of Public Citizen, we write to express our views on the Federal Reserve Board's (Board) proposal regarding the addition of a minimum level of long term debt that would convert to equity in the event of failure at a large bank holding company.

The Board explains that the new form of debt capital is intended to strengthen the ability of the largest domestic and foreign banks operating in the United States to be fail without extraordinary government support or taxpayer assistance. The proposed rule would apply to domestic firms identified by the Board as global systemically important banks (GSIBs) and to the U.S. operations of foreign GSIBs. These institutions would be required to meet a new long-term debt requirement and what the Board calls a new "total loss-absorbing capacity," or TLAC, requirement. The Board labels this debt "loss absorbing" because in the event of failure, it would be converted into equity, leaving the issuing firm no obligation to repay the debt principle.

The Board explains that an orderly resolution process should allow a GSIB to fail, and its investors to suffer losses, while the critical operations of the firm continue to function. Requiring GSIBs to hold sufficient amounts of long-term debt, which can be converted to equity during resolution, would facilitate this by providing a source of private capital to support the firms' critical operations during resolution.

For domestic GSIBs, the proposed long-term debt requirement would set a minimum level of long-term debt that could be used to recapitalize these firms' critical operations upon failure. The complementary TLAC requirement would set a new minimum level of total loss-absorbing capacity, which can be met with both regulatory capital and long-term debt. The Board states that these requirements will improve the prospects for the orderly resolution of a failed domestic GSIB and will strengthen the resiliency of all GSIBs. We agree with this assertion, but as we will discuss below, we believe the reliance on additional debt compounds the problem of leverage (the ratio of assets to equity), including the incentives for bankers to take risks that can lead to profits for equity holders.

Domestic GSIBs would be required to hold at a minimum:

- A long-term debt amount of the greater of 6 percent plus its GSIB surcharge of risk-weighted assets and 4.5 percent of total leverage exposure; and
- A TLAC amount of the greater of 18 percent of risk-weighted assets and 9.5 percent of total leverage exposure.

This increases by roughly 60% the long-term debt requirement for the large banks.

The proposal would also require the parent holding company of a domestic GSIB to avoid entering into certain financial arrangements that would create obstacles to an orderly resolution. These "clean holding company" requirements would include bans on issuance of short-term debt to external investors and on entering into derivatives and certain other types of financial contracts with external counterparties. These requirements are intended to reduce the risk of destabilizing funding runs at the holding company, reduce holding company complexity, and enhance the resiliency of operating subsidiaries during an orderly resolution. The proposal also includes regulatory capital deductions for Board-regulated banking firms that hold unsecured debt of the parent holding companies of domestic GSIBs.

In isolation, we generally support this proposal. It should make a taxpayer rescue of a mega-bank less likely. It establishes a type of security that provides a kind of win-win, A win for bank managers who are compensated in equity and don't wish the bank to dilute the level of stock; and a win for prudential regulators (and the taxpayers they represent) who don't want to bail out another mega-bank.

In the context of what's needed for banking safety, however, we think the use of additional debt goes in the wrong direction. We will discuss this more fully in point No. 1.

The Board chooses to use the abbreviation TLAC—total loss absorbing capacity. We are concerned that such terminology obscures and even misinforms public policy. This proposal, at its core, proposes that average investors who ordinarily view bonds as a safer option than stocks will be responsible for effectively bailing out failed mega-banks. Absorption might connote the sparkling results of a diligent kitchen cleaner, but it hardly describes how a pensioner might feel when her benefits are cut. This is not some neutral "loss absorption;" it is instead, a "loss suffering" device. It is better understood as "bail-in" deb.

We are concerned that this proposal reflects a flawed assumption about who is responsible for bank failure. We believe that bank managers bear responsibility, and they should be held accountable in the case of bank mismanagement.[1]

Summary

We offer the following broad comments.

1. The Board should require equity buffers instead of requiring more debt.
2. Senior managers should be required to purchase a substantial portion of the TLAC debt, and the debt constitutes a substantial portion of senior management pay. We oppose this proposal without this requirement.
3. The Board should prescribe text for the specific warning about the nature of this debt. The bail-debt should only be sold to qualified, sophisticated investors. Pension funds should be excluded from the market, as well as investors not accredited by the SEC.
4. Any TLAC debt level should be well above one informed by the last financial crisis; it should be an aggregate 30 percent instead the 19 percent the Board proposes.
5. There should be limits on dividend and bonus payments where the firm falls below required TLAC limits.

[1] At the extreme, some bankers believe the public is ultimately responsible. HSBC Chairman Douglas Flint has argued that "society" must bear the costs of addressing mega-bank failures. "At the end of the day, the burden of failure rests with society. Whether you take it out of society's future income through taxation or whether you take it through their pensions or savings, society is bearing the cost." U.K. House of Lords, *Review of the EU Financial Regulatory Framework*, Unrevised transcript of evidence taken
before the Select Comm. on the European Union, Sub-Comm. A [Econ. & Fin. Affairs], 21 Oct. 2014 (testimony of
Douglas Flint) (emphasis added) [hereinafter 2014 Flint Testimony], available at
http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-sub-a-economic-andfinancial-
affairs-committee/review-of-the-eu-financial-regulatory-framework/oral/14795.html. As George Washington Prof. Art Wilmarth observed, this "remarkable statement exposes the assumption of megabanks that society --including taxpayers, pensioners, and retail investors -- must cover the costs" of a mega-bank failure. "Mr. Flint's assertion reflects the attitude that has prevailed on Wall Street . . . both before and during the financial crisis." This is an attitude where "insiders should retain their profits and bonuses from high-risk activities while governments and taxpayers must bear the losses. "The Financial Industry's Plan for Resolving Failed Megabanks," by Art Wilmarth, GW Law, (Fall 2015), available at:
http://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2403&context=faculty_publications

1. Equity, not more debt

The 2008 financial crisis revealed that the real (as opposed to reported) difference between major bank assets and liabilities was woefully small. In fact, the assets were not really worth what the banks claimed. They consisted of securities related to the housing market, where fraudulent, overzealous sales created a bubble that abruptly burst. Banks quickly ran through cash reserves and could not liquidate newly discounted assets at sufficient levels to satisfy their very real debt obligations.

To forestall a repeat of this 2008 crisis, the Board proffers a proposal that relies on debt. The problem of the 2008 crisis is that large banks owed too much in debt. Yet the Board proposes that the answer to this problem is more debt. Granted, the Board proposes that the debt be of a specific nature. Namely, it is debt that will be converted to equity in the event the bank holding company fails. But these are accounting terms, not a concrete acknowledgement of who suffers loss. What this means in practice is that a bank that falters will simply declare that a portion of the money it owes in these new TLAC bonds will not be paid. Those investors who hold the bonds will instead be considered the same as shareholders, and thus lose their money

Ideally, the Board would require that large banks operate with substantial equity. By this we mean that firm assets should be worth considerably more than its liabilities. We propose that this difference be 20 percent, a level discussed in previous comments to the Board. [3]

Investors who buy bank stocks hold an ownership claim on the firm's assets. Legally, these owners exercise the right to elect board members, to replace those who a majority of shareholders believe are failing to oversee management, to call for new management, to submit resolutions for a shareholder vote that change the governance and even the operations of the company.

As owners, shareholders can claim the value of the firm's profits. In a thriving business, these profits rise. This is reflected in the share price, which is the present value of future earnings. The value of the stock also tracks the difference between the firm's assets and liabilities.

We believe the Board's proposal is a classic attempt to have your cake and eat it too. What's needed is greater shareholder equity, that is, a greater difference between the value of the firm's assets and its liabilities. When that difference falls below a certain level, the Board should order the firm to suspend dividends and sell more equity shares. Selling convertible debt sustains the harmful dynamic of a management that hopes to reduce the amount of equity presumably to maximize equity-based compensation leverage.

[3] See Comment to Federal Reserve on Basel III Capital Requirements, Public Citizen, by Bartlett Naylor, (2012), available at: https://www.fdic.gov/regulations/laws/federal/2012-ad-95-96-97/2012-ad-95-96-97_c_1056.pdf

2. Management must be compensated in TLAC debt

One of the central hazards that led to the 2008 crash turned on the use of stock options to compensate bank managers. Stock-based compensation motivated bank managers to take immense risks, since the rewards would be extraordinary. Stock-based compensation also biased managers to reduce the proportion of stock funding at the bank; since the fewer the shares, the greater the profit per share. [4]

It is necessary to realign bank manager interests with the stability of the bank. If the Board adopts this proposal, it must require that bankers be compensated with this new TLAC debt. If the bank is run safely, the bonds pay. If the managers run the bank recklessly and fail, the bail-in debt turns to equity with not promise of any repayment (but simply an ownership claim on the company.)

We insist that a substantial portion of senior banker compensation consist of bail-in bonds, and that a substantial portion of the bail-in bond investors be senior bankers.

We believe that current compensation at the largest banks can provide a significant pool for this bail-in debt market. In 2008, the nine largest banks paid collective bonuses of $32 billion even as they received several hundred billion dollars in taxpayer assistance. [5] While we are not privy to senior compensation at the banks, nor what proportion is incentive-based, we note that in 2014, JP Morgan's non-interest expense was $61 billion.[6] We assume that much of this is compensation. If a portion of this compensation must be in bail-in bonds, this will go a substantial way in meeting the Board's requirements.

Firm specific estimates of the amount of bail-in debt puts JP Morgan at about $19 billion. (Wells Fargo would need $46 billion, Citigroup $14 billion, and Bank of America 6 billion.) [7] If JP Morgan and the other large banks compensate senior managers with bail-in debt over several years, this could result in senior managers largely responsible for bailing out their own banks in the event of failure when their bail-in bonds convert to equity.

3. Limits and Warnings to Investors

We support the Board's proposed requirement that the dangers of the bail-in bonds be spelled out for investors. Bankers skilled in salesmanship, however, may fall short in truly impressing potential investors with danger. See, for example, the Senate Permanent Subcommittee on Investigations hearings on the Goldman Sachs "Abacus" deal, where the firm knowingly sold toxic assets to investors while burying the warning in the following boilerplate misdirection. "Goldman Sachs is currently and may be from time to

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7[4] See comment, Americans for Financial Reform, (2015), available at: http://www.federalreserve.gov/SECRS/2014/October/20141021/R-1410/R-1410_091814_129625_299887419252_1.pdf

[5] "Banks Paid $32.6 billion in bonuses," Bloomberg (June 2009) available at: http://www.hermes-press.com/bank_bonuses.htm

[6] JP Morgan annual report, (2015), available at: http://www.sec.gov/Archives/edgar/data/19617/000001961715000272/corp10k2014.htm

[7] See speech, FDIC Chair Tom Hoenig, (Jan. 20, 2016), available at: Other estimates find similar results, and firm-specific estimates are quite revealing. For example, Credit Sights findings "estimate that Wells Fargo has the biggest shortfall at $46 billion, with JPMorgan a distant second at $19 billion, followed by Citigroup at $14 billion, Bank of America at $6 billion and State Street at $2 billion

time in the future an active participant on both sides of the market and have long or short positions" and the firm may have "potential conflicts of interest."[8] We find such a warning insufficient.

We suggest that the following warning be required for all bail-in debt issues, and this warning be printed on the cover of any sales document.

> "Warning. This debt poses serious risks... You may lose the entire value of your investment. This debt was devised by the government to be substituted for a taxpayer bailout. In the event the government decides that this bank holding company is not viable, your entire investment may be lost."

Further, we ask that the bonds be sold only to accredited investors, as defined by the Securities and Exchange Commission.[9] Selling bail-in bonds to average investors or pension fund would mean that the Board has decided that this segment of the population would be responsible for bailing out large banks in the event of failure. By requiring only accredited investors be allowed to purchase the bail-in debt, a bailout will fall on those who are more readily able to suffer the losses.

4. The 19 percent solution

The Board proposes a specific amount of this new debt. This proposal is contained in a matrix, and what applies to each bank varies according to the bank's funding profile. The Board calibrates its proposed requirement on an analysis of the historical losses of the major financial institutions during financial crises in a report called "The Supervisory Capital Assessment Program: Overview of Results." [10]We believe this is a reasonable place to establish a floor. The analysis found that the bank holding company with the most severe problems suffered estimated losses and recapitalization needs of roughly 19 percent of risk-weighted assets.[11] But it seems unwise under the precautionary principle to establish safety limits only that respond to the most recent crash. We urge the Board to establish a safer buffer and suggest that 30 percent is a better figure.

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[8] See discussion in "Limits to Disclosure," by Steven Solomon, Univ of California (2012) available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2168427
[9] See SEC explanation, available at: http://www.sec.gov/answers/accred.htm
[10] "The Supervisory Capital Assessment Program: Overview of Results.", Federal Reserve, (May 7, 2009), available at *http://www.federalreserve.govnewsevents/press/bcreg/bcreg20090507a1.pdf.*

[11] "Supervisory Capital Assessment Program," Federal Reserve Board (May 2009); Available at: http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf

5. Dividends

We support the Board's recommendation that dividend payments be suspended in the event that firms fall below required capital limits. However, the rubric the Board proposes should be stricter. Instead of allowing some dividends to be paid calibrated to the amount of the shortfall in capital, it should be an all or nothing proposition. When a bank's capital levels fall below requirements, all dividends should be suspended.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org, or 202.580.5626

Sincerely,

Public Citizen.

Bartlett Naylor